What You Need to Know About Dividend Investing

Description

Dividend investing is one of the simplest forms of investing. Companies must maintain profitability to remain operational for a long time. Sustained profitability is just as important to pay a healthy dividend.

Paying dividends is a company’s way of sharing profits with its shareholders. Typically, the dividend companies that publicly trade on the Toronto Stock Exchange pay a dividend every three months or every month, though dividends are known to be paid semi-annually or annually as well.

When companies start paying dividends, it’s difficult for them to stop paying them, because it’d look bad; their reputation would be somewhat tainted in the investment community. However, dividend cuts are more common than you think.

Companies that operate in industries which are subject to cyclicality will experience more volatile earnings. So, dividend investors need to be careful about the kinds of companies they’re buying for dividends. For example, in the last few years, we’ve witnessed dividend cuts in the energy and mining sectors.

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What makes a healthy dividend?

The simplest way to filter out unsustainable dividends is to look at a company’s earnings and dividends for the year.

I’ll use **Royal Bank of Canada** (TSX:RY)(NYSE:RY) as an example. In the fiscal year which ended in October 2016, it paid out dividends per share of $3.24 and generated earnings per share of $6.96. As a result, its payout ratio was just under 47%.

In other words, the top bank retained about 53% of its earnings to grow its business. Additionally, Royal Bank’s payout ratio aligns with the rest of the Big Five banks, which have payout ratios of roughly 50%. So, the bank pays a healthy dividend.

For some companies, it’s more accurate to use cash flows instead of earnings to determine their dividend safety. That’s because their depreciation expenses reduce their reported earnings, but these expenses are actually non-cash items.

Enbridge Inc. (TSX:ENB)(NYSE:ENB) is a good example. Its 2016 payout ratio based on its earnings is about 92%, which seems to indicate its dividend has little margin of safety.

However, it generates healthy cash flow to sustain a growing dividend. Specifically, the company aims to pay out up to 50% of its adjusted cash flow from operations.

Typically, companies which have paid growing dividends over time offer safer dividends. After all, this shows that they've been profitable and have a culture of sharing their growing profitability with their shareholders.

What dividend investing isn't

Dividend investing is considered a defensive form of investing. Although it doesn't protect your stock portfolio in a downturn, you can still get a positive return from dividends, while you wait for your shares to turn around.

Dividend investing also doesn't prevent investors from choosing a bad company or overpaying for the shares of a company.

The takeaway

Both Royal Bank and Enbridge are great dividend companies. Royal Bank has paid a dividend for over a century and has increased it for six consecutive years.

Enbridge has paid a dividend for over six decades and has increased it for 21 consecutive years.

Both companies are capable of growing their dividends again this year!

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Author
kayng